

**The Federal, State, and Local Governments  
Office Needs Additional Information to Assess  
the Productivity of Compliance Checks and  
Assist Its Compliance and Outreach Efforts**

**August 2004**

**Reference Number: 2004-10-145**

**This report has cleared the Treasury Inspector General For Tax Administration disclosure review process and information determined to be restricted from public release has been redacted from this document.**



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220

INSPECTOR GENERAL  
for TAX  
ADMINISTRATION

August 10, 2004

MEMORANDUM FOR COMMISSIONER, TAX EXEMPT AND GOVERNMENT  
ENTITIES DIVISION

*Gordon C. Milbourn III*

FROM: Gordon C. Milbourn III  
Acting Deputy Inspector General for Audit

SUBJECT: Final Audit Report - The Federal, State, and Local Governments  
Office Needs Additional Information to Assess the Productivity of  
Compliance Checks and Assist Its Compliance and Outreach  
Efforts (Audit # 200410017)

This report presents the results of our review of the Federal, State, and Local Governments (FSLG) office's compliance check process. The overall objective of this review was to assess the FSLG office's processes for identifying and assigning compliance checks and analyzing the results to identify compliance and outreach needs. In Fiscal Year (FY) 2004, the FSLG office plans to achieve a better balance among educational activities, claims resolution, and traditional compliance work. For FY 2004, the FSLG Business Plan calls for increasing compliance enforcement activities (examinations and compliance checks) to 75 percent of available direct time, while reducing outreach activities to 25 percent of direct time.

In summary, FSLG office management has implemented a process to identify and assign compliance check cases for review by FSLG office field personnel and is currently attempting to assess the productivity of their identification process. However, they do not have a structured process nationwide to capture and analyze the results of compliance check activity. As a result, FSLG office management does not know the effectiveness of these efforts or if these cases are identifying significant areas of noncompliance for future education and compliance activities.

To assess the productivity of compliance check cases, FSLG office management initiated a test in January 2004 in the Gulf Coast FSLG office field group. FSLG office management informed us this test is in its early stages and no cases had been closed as of April 20, 2004. We identified two opportunities to improve the form used in this test to capture the results of the compliance check. These additional data will enable

FSLG office management to more fully assess the case identification process and determine how to improve compliance check efforts.

Additionally, we interviewed four FSLG Area Office managers to determine the process followed in assigning compliance check cases for review by field specialists and identified a practice that could result in unequal taxpayer treatment. Three of the four managers interviewed stated that they periodically request compliance check cases from Outreach, Planning, and Review office personnel and assign them to specialists for review as a compliance check. In contrast, one manager stated that examinations are a better use of staff resources due to the high experience level of the staff. As a result, this manager requested a low number of compliance check cases and indicated that compliance check cases were frequently converted to examinations prior to case initiation.

We recommended the Director, Government Entities, develop a structured process to systemically track and analyze the results of compliance check cases, revise the Return Inventory and Classification System (RICS)<sup>1</sup> Query Sheet to separately evaluate the productivity of each RICS query and clarify instructions for the information to be tracked, and ensure each FSLG Area Office's process for completing compliance check cases results in equal taxpayer treatment.

Management's Response: Tax Exempt and Government Entities Division management agreed with the recommendations contained in the report. FSLG office management will incorporate the results of compliance checks into a database to track results and issues. FSLG office management announced a vacancy to fill a position in the Classification unit in Austin, Texas, to analyze these data to identify trends, issues, and opportunities for compliance, education, and guidance. FSLG office management has also revised the RICS query evaluation process to separately evaluate the effectiveness of each query and has clarified instructions on the RICS Query Sheet as to what information is included in "other issues identified." Additionally, FSLG office management will specify that all managers must follow the same process when ordering compliance checks and converting compliance checks to examinations in the implementing instructions for annual workplans beginning October 1, 2004, and in all group operational reviews begun after July 1, 2004. Management's complete response to the draft report is included as Appendix IV.

Copies of this report are also being sent to the IRS managers affected by the report recommendations. Please contact me at (202) 622-6510 if you have questions or Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs), at (202) 622-8500.

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<sup>1</sup> The RICS contains return and filer information related to the filing and processing of Employee Plans, Exempt Organizations, and Government Entities forms.

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**Background**

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One of the offices in the Government Entities (GE) function of the Tax Exempt and Government Entities (TE/GE) Division is the Federal, State, and Local Governments (FSLG) office. Its mission is to provide approximately 87,000 Federal Government agencies, state governments, local governments, and quasi-governmental entities top-quality service by helping them understand and comply with the tax laws. The FSLG office's interactions with its customer base affects compliance levels of the government employers as well as their 23 million employees, which is the largest single block of employees in the United States (U.S.). According to the FSLG office's Fiscal Year (FY) 2004 Workplan, these entities employ 20 percent of the U.S. workforce and pay wages in excess of \$760 billion and employment taxes in excess of \$200 billion annually.

To accomplish its mission, the FSLG office uses a combination of educational and compliance activities to provide service to its customers. FSLG office customers are generally not subject to Federal income tax; however, these customers are generally required to file information returns and file and pay employment and excise taxes. During its initial years<sup>1</sup> of existence, the FSLG office focused primarily on outreach to and education of its customers. The primary objective of outreach is to increase voluntary compliance by helping customers understand Internal Revenue Service (IRS) filing and reporting requirements and how to accurately and timely file tax returns and any other required returns. In FY 2003, the FSLG office allocated 60 percent of available resources to outreach activities. Examination activity during the initial startup years generally focused on limited scope audits and claims for refunds by FSLG office customers.

In FY 2004, the FSLG office plans to achieve a better balance among educational activities, claims resolution, and traditional compliance work. For FY 2004, the FSLG Business Plan calls for increasing compliance enforcement activities (examinations and compliance checks) to

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<sup>1</sup> The FSLG office was established in FY 2000 as part of the Internal Revenue Service's modernization process.

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75 percent of available direct time, while reducing outreach activities to 25 percent of direct time.

The increased emphasis on compliance activities is designed to create a more balanced, effective, and informed program. The goals of this increased emphasis are to:

- Identify significant areas of (non)compliance for future education and compliance activities.
- Determine the effectiveness of the FSLG office's educational efforts and their effects on compliance.
- Establish a compliance presence in all FSLG office market segments.
- Develop baselines for future actions.

The FSLG office acknowledges that effective workload planning for this increased emphasis is a challenge due to the lack of FSLG office compliance benchmarks and baseline measures. According to the FSLG office's FY 2004 Workplan, its customers have not been the subject of significant research or information-gathering activity. As a result, accurate and statistically valid data related to compliance levels and indicators of noncompliance are not available to assist FSLG office management in selecting cases for review.

The FSLG Outreach, Planning, and Review (OPR) office is responsible for the overall operational development, planning, and program monitoring for the FSLG office, including identifying and assigning compliance checks. A compliance check is a contact with the customer that involves a review of filed information and tax returns of the entity to educate the taxpayer, encourage compliance and self-correction, and identify customer needs. A compliance check is not an examination, inspection, or discussion of books and records and does not involve a determination of tax liability. Additionally, the FSLG office customer may legally choose not to participate in the compliance check. In FYs 2002 and 2003, FSLG office specialists completed 36 and 690 compliance checks, respectively. The FSLG office has a goal to complete 420 compliance checks in FY 2004.

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We conducted our audit during the period February through May 2004 at the TE/GE Division Headquarters Office in Washington, D.C., as well as the OPR and Gulf Coast Area Offices in Austin, Texas. We also contacted personnel located in FSLG offices in Pittsburgh, Pennsylvania; Rochester, New York; and Walnut Creek, California. The audit was conducted in accordance with *Government Auditing Standards*. Detailed information on our audit objective, scope, and methodology is presented in Appendix I. Major contributors to the report are listed in Appendix II.

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**Additional Information Should Be Captured and Analyzed to Evaluate and Improve the Compliance Check Process**

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FSLG office management has implemented a process to identify and assign compliance check cases for review by FSLG office field personnel and is currently attempting to assess the productivity of their identification process. However, they do not have a structured process nationwide to capture and analyze the results of compliance check activity. As a result, FSLG office management does not know the effectiveness of these efforts or if these cases are identifying significant areas of noncompliance for future education and compliance activities. This analysis is vital because the primary goal of compliance checks is to educate customers about their tax filing requirements rather than to ensure compliance. As such, it is difficult to determine their specific impact on voluntary compliance. A more structured process that captures compliance check information and provides baseline measures would enable FSLG office management to conduct trend analyses and determine what impact compliance checks have on educating customers and ensuring compliance.

FSLG Area Office managers provide written requests for compliance checks to OPR office personnel on a periodic basis throughout the year. OPR office personnel will perform research to identify compliance check cases based on the requests, provide the cases to the Area Office managers, and update their inventory database to reflect the case assignments.

OPR office personnel use the following process to identify compliance check cases for assignment to the field groups. Currently, OPR office personnel's main source of

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compliance check cases is employment tax return information. Specifically, OPR office personnel analyze the Employer's Quarterly Federal Tax Return (Form 941) data maintained on the Return Inventory and Classification System (RICS).<sup>2</sup> OPR office personnel run certain predefined RICS queries to identify line items that appear to be outside the normal ranges when compared to other line items on the Form 941. These line items include total compensation, Medicare wages, and income tax withheld. Based on the results of these queries, OPR office personnel judgmentally prioritize cases for assignment to the field based on the highest indicators of potential noncompliance. The Area Office managers are responsible for assigning the compliance check cases to field specialists for review and providing oversight during case processing. OPR office management receive a monthly status report detailing the number of compliance check cases currently assigned to the field groups as well as case closing data.

Although Form 941 compliance data on the RICS are the primary emphasis for compliance check cases, the FSLG office's FY 2004 Workplan indicates that compliance check cases will also address U.S. Information Return (Form 1099) filing compliance issues. However, the OPR office analyst responsible for identifying compliance check cases stated that the Form 1099 database has not been queried for approximately 2 years. According to the analyst, the IRS Small Business/Self-Employed Division is responsible for providing this information and has experienced difficulty in extracting these data from the IRS computer system. However, the responsible OPR office analyst stated that Calendar Year 2002 data from the Form 1099 database was expected to be provided to the OPR office by May 2004.

Another source for compliance check cases is the Annual Summary and Transmittal of U.S. Information Returns (Form 1096). In May 2003, the OPR office analyst developed an additional RICS query using the Form 1096

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<sup>2</sup> The RICS contains return and filer information related to the filing and processing of Employee Plans, Exempt Organizations, and GE forms.

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table to identify the volume of Forms 1099 filed by an entity.

### **Potential examination and outreach issues identified through compliance check cases are not systemically tracked**

According to the FSLG office's FY 2004 Workplan, the results of compliance checks will be used to develop issues for examination consideration and identify customer needs for additional education and outreach. For example, if a compliance check showed that the Form 941 contained incorrect calculations because of a misunderstanding of the instructions, FSLG office management could determine if this was a common problem and take steps to address it through clearer instructions. However, we determined that FSLG office management does not currently have a structured process to systemically track and analyze the results. This information would enable FSLG office management to use their scarce resources more productively by focusing compliance check cases on the returns with the highest risk of noncompliance, identifying potential issues for future examination work, and addressing customer education needs.

Based on our interviews with FSLG Area Office managers, FSLG office specialists document the results of their compliance check cases in the case files. Specifically, issues identified may be documented in case history notes and closing letters to FSLG office entities. In addition, FSLG office specialists can document noncompliance issues in Discrepancy Reports that could be used for future follow-up actions. Although this historical information for FY 2002 to date is available in the case files, it has not been systemically captured in an information system to facilitate any type of review and analysis.

FSLG office management agreed there is a need to develop a process to systemically capture and analyze compliance check data for future compliance and outreach activities. In June 2003, a new Director of the FSLG office was selected and plans to develop a process to systemically capture and analyze compliance check data for future compliance and outreach activities. The new Director, however, has been

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focusing on other higher priorities, such as identifying the customer base, developing examination guidelines, initiating a market segment strategy, and addressing continued understaffing, which have limited FSLG office management's efforts to begin developing this structured process.

Although FSLG office management has other priorities and limited resources, this type of structured process will enable FSLG office management to increase productivity by focusing on key areas of noncompliance and targeting outreach and examination activities.

### **The usefulness of the Gulf Coast RICS test can be improved by tracking additional information**

To assess the productivity of compliance check cases, FSLG office management initiated a test in January 2004 in the Gulf Coast FSLG office field group. FSLG office management stated that the purpose of the test is to assess whether the RICS queries currently used to identify compliance check cases are resulting in productive cases for review (i.e., cases with noncompliance and/or education issues).

FSLG office management informed us this test is in its early stages and no cases had been closed as of April 20, 2004. We identified two opportunities to improve the form used to capture the results of the compliance check cases. These additional data will enable FSLG office management to more fully assess the case identification process and determine how to improve compliance check efforts.

The Gulf Coast field group is currently the only FSLG office field group participating in this test. The process used to identify, assign, and work these cases is the same as that used in the other field groups. The difference is that OPR office personnel prepare a unique case survey sheet (RICS Query Survey) for each test case<sup>3</sup> that identifies the RICS query/queries used for case identification. The FSLG office field specialist is required to complete the sheet upon case

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<sup>3</sup> Cases that have been opened and closed after January 1, 2004, are included in the test.

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closing to assess the productivity of the query/queries (i.e., to indicate whether the query identified an area of noncompliance) and to document if other compliance action, such as an examination, is necessary to determine if the customer is in compliance. OPR office personnel input data from this sheet to a Microsoft Access® database for tracking and analysis purposes. The types of data input include the RICS queries used to identify the case; the results of the compliance check; the specialists' feedback about the productivity of the RICS queries; and other miscellaneous comments. Depending upon the success of the test, FSLG office management stated that they might require all field personnel to complete the case survey sheet.

Our interviews with the applicable OPR office personnel responsible for conducting the RICS research indicated that one or more RICS queries could be the primary source of the case identification. For example, a case could be generated based on two different queries that were outside the acceptable ranges. The case survey sheet would show a check mark for these two queries that would alert the field specialist about the two areas needing a compliance check. However, in this example, the survey sheet currently only allows for a single check box to evaluate the productivity of both RICS queries, not whether each query was productive. To assess the productivity of each RICS query, the FSLG office specialist should complete a separate check box so the results for each RICS query can be tracked.

In addition, we believe guidelines for completing the survey sheet can be clarified to enable the FSLG office to capture the information needed to determine future compliance and outreach needs of customers. The survey sheet currently includes a line item ("other issues identified") that could provide the field specialists an opportunity to record miscellaneous comments, such as the specific reasons for an entity's noncompliance with tax filing and/or reporting requirements, as well as issues identified. General instructions about how the survey sheet should be implemented were communicated in an email sent to the Gulf Coast Area Office manager. However, the instructions for preparing the survey sheet do not discuss the purpose of this line item. Our interviews with FSLG office personnel

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identified differences in the information that could be captured in this line item. As a result, information may not be consistently captured for all cases.

By ensuring this additional information is captured, FSLG office management will have more complete information about the productivity of the various RICS queries and will be better able to make an informed business decision regarding how to focus compliance check cases as well as future compliance and education activities.

### **Inconsistencies in how field personnel conduct compliance checks could result in unequal treatment of taxpayers**

We interviewed four FSLG Area Office managers to determine the process followed in assigning compliance check cases for review by field specialists and identified a practice that could result in unequal taxpayer treatment. Three of the four managers interviewed stated that they periodically request compliance check cases from OPR office personnel and assign them to specialists for review as a compliance check. In contrast, one manager stated that examinations are a better use of staff resources due to the high experience level of the staff. As a result, this manager requested a low number of compliance check cases and indicated that compliance check cases were frequently converted to examinations prior to case initiation.

TE/GE Division procedures allow field specialists to convert a compliance check to an examination after initiating the case, if warranted. However, as stated earlier, examinations are not conducted in the same manner as compliance checks. Unlike in the examination process, FSLG office customers have an option not to participate in a compliance check. Further, FSLG office specialists do not assess additional tax liabilities as a result of a compliance check case.

As a result of this inconsistent practice, we believe the potential exists for unequal taxpayer treatment. Therefore, FSLG office management should reevaluate this practice.

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**Recommendations**

To improve the productivity of compliance checks and better enable the FSLG office to achieve its goals, the Director, GE, should:

1. Develop a structured process to systemically track and analyze the results of compliance check cases to identify significant areas of noncompliance for future education and compliance activities.

Management's Response: FSLG office management will track the results and issues relating to compliance checks in a database. FSLG office management announced a vacancy to fill a position in the Classification unit in Austin, Texas, to analyze these data to identify trends, issues, and opportunities for compliance, education, and guidance.

2. Revise the RICS Query Sheet to separately evaluate the productivity of each RICS query and clarify instructions for the information to include on the "other issues identified" line item.

Management's Response: FSLG office management has revised the RICS query evaluation process to separately evaluate the effectiveness of each query and has clarified instructions on the RICS Query Sheet as to what information is included in "other issues identified."

3. Ensure each FSLG Area Office's process for completing compliance check cases is resulting in equal taxpayer treatment.

Management's Response: FSLG office management will specify that all managers must follow the same process when ordering compliance checks and converting compliance checks to examinations in the implementing instructions for annual workplans beginning October 1, 2004, and in all group operational reviews begun after July 1, 2004.

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**Appendix I**

**Detailed Objective, Scope, and Methodology**

The overall objective of this review was to assess the Federal, State, and Local Governments (FSLG) office's processes for identifying and assigning compliance checks and analyzing the results to identify compliance and outreach needs. To accomplish our objective, we:

- I. Determined if FSLG office management is providing adequate oversight to FSLG office compliance checks.
  - A. Interviewed responsible FSLG office management to identify their roles and degrees of oversight provided for compliance checks.
  - B. Determined if the FSLG office has established any measures assessing the impact of compliance check cases on the compliance of FSLG office entities.
  - C. Determined if an Action Plan was developed for identifying and assigning compliance checks and monitoring the results of FSLG office compliance checks.
- II. Assessed the process followed by FSLG office management to identify, prioritize, and assign compliance checks.
  - A. Interviewed Outreach, Planning, and Review (OPR) office personnel, reviewed documentation to determine the adequacy of sources used to identify potential compliance check cases, and determined the frequency of queries performed during the period October 1, 2002, through December 31, 2003.
  - B. Interviewed OPR and FSLG office field personnel to determine the process for prioritizing and assigning compliance checks.
- III. Assessed the process followed by FSLG office management to identify compliance and outreach needs based on the results of compliance checks.
  - A. Obtained any statistics showing the number of compliance check cases identified, the number of cases worked, and the results of compliance checks.
  - B. Ascertained if the results of FSLG office compliance checks are tracked and analyzed effectively to identify compliance and outreach needs.

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**Appendix II**

**Major Contributors to This Report**

Daniel R. Devlin, Assistant Inspector General for Audit (Headquarters Operations and Exempt Organizations Programs)

Nancy Nakamura, Director

Jeffrey M. Jones, Audit Manager

Margaret Anketell, Lead Auditor

Deadra English, Senior Auditor

Michael McGovern, Auditor

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**Appendix III**

**Report Distribution List**

Commissioner C  
Office of the Commissioner – Attn: Chief of Staff C  
Deputy Commissioner for Services and Enforcement SE  
Director, Communications and Liaison, Tax Exempt and Government Entities Division  
SE:T:CL  
Director, Government Entities, Tax Exempt and Government Entities Division SE:T:GE  
Director, Office of Federal, State, and Local Governments, Tax Exempt and Government Entities  
Division SE:T:GE:FSL  
Chief Counsel CC  
National Taxpayer Advocate TA  
Director, Office of Legislative Affairs CL:LA  
Director, Office of Program Evaluation and Risk Analysis RAS:O  
Office of Management Controls OS:CFO:AR:M

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Appendix IV

Management's Response to the Draft Report



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

RECEIVED  
AUG 03 2004

JUL 27 2004

MEMORANDUM FOR ACTING DEPUTY INSPECTOR GENERAL FOR AUDIT

FROM: Steven T. Miller *STM/Sarah K. Hoffman*  
Commissioner, Tax Exempt and Government Entities

SUBJECT: The Federal, State and Local Governments (FSLG) Office Needs Additional Information to Assess the Productivity of Compliance Checks and Assist Its Compliance and Outreach Efforts (Audit # 200410017)

Thank you for the opportunity to respond to your draft report concerning our compliance check process and the data collection efforts. The review considered classification, assignment, and FSLG analysis of results of compliance checks.

Overall, we agree with the draft report's conclusions. For FSLG and for our customer base, examinations and compliance checks are a new process designed to achieve the best compliance coverage in light of FSLG staffing. As we expand our compliance activities, we recognize the need to develop additional data to evaluate and monitor these processes. We also agree that we must take steps to improve consistency across our field groups.

**RECOMMENDATION 1:**

Develop a structured process to systemically track and analyze the results of compliance check cases to identify significant areas of noncompliance for future education and compliance activities.

**CORRECTIVE ACTION 1:**

FSLG will incorporate the results of compliance checks into a database to track results and issues. FSLG will gather this information in the classification unit in Austin, TX and analyze the data to identify trends, issues and opportunities for compliance, education and guidance. FSLG is announcing a vacancy to fill a position in the Austin classification unit to perform this analysis and for other classification related issues. This announcement will be posted in the July 23, 2004 COL.

**IMPLEMENTATION DATE:**

December 31, 2004

**RESPONSIBLE OFFICIAL:**

Director, Federal, State and Local Governments, Tax Exempt and Government Entities

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**CORRECTIVE ACTION MONITORING PLAN:**

The Manager of Federal, State and Local Governments - Outreach, Planning and Review will advise the Director, Federal, State and Local Governments when the modifications are made. The data obtained through this process will be analyzed for issues that may require additional educational, compliance or guidance emphasis.

**RECOMMENDATION 2:**

Revise the RICS Query Sheet to separately evaluate the productivity of each RICS query and clarify the instructions for the information to be included on the "other issues identified" line item.

**CORRECTIVE ACTION 2:**

FSLG has revised the RICS query evaluation process to separately evaluate the effectiveness of each query used to select the case. We have clarified the instructions on the RICS Query Sheet as to what information is included in "Other Issues Identified" to ensure consistency in the responses.

**IMPLEMENTATION DATE:**

Completed

**RESPONSIBLE OFFICIAL:**

Director, Federal, State and Local Governments, Tax Exempt and Government Entities

**CORRECTIVE ACTION MONITORING PLAN:**

These actions have been completed.

**RECOMMENDATION 3:**

Ensure each FSLG Area Office's process for completing compliance check cases is resulting in equal taxpayer treatment.

**CORRECTIVE ACTION 3:**

We recognize that there are taxpayer consistency and fairness issues when subordinate organizations deviate from work plan objectives. FSLG management will address this issue in the implementing instructions for annual workplans beginning October 1, 2004. We will specify the same process all managers must follow when ordering compliance checks and converting compliance checks to exams and in all group operational reviews begun after July 1, 2004. However, the ability to convert compliance checks to examinations is an integral part of the FSLG compliance program. This is ultimately within the manager's discretion.

**IMPLEMENTATION DATE:**

October 30, 2004

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**RESPONSIBLE OFFICIAL:**

Director, Federal, State and Local Governments, Tax Exempt and Government Entities

**CORRECTIVE ACTION MONITORING PLAN:**

The Manager of Federal, State and Local Governments - Outreach, Planning and Review will advise the Director, Federal, State and Local Governments on the status and consistency of field conversions of compliance checks to examinations. Managerial performance issues arising from this recommendation will be addressed by the Director.